Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

In the Matter of	)	
	)	
Petition of U S WEST Communications, Inc. for Forbearance from Regulation as a Dominant Carrier in the Phoenix, Arizona MSA	))))	CC Docket No. 98-157

REPLY COMMENTS OF U S WEST COMMUNICATIONS, INC.

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SUMMARY

U S WEST Communications, Inc. ("U S WEST") hereby submits its reply comments in support of its Petition requesting that the Federal Communications Commission ("Commission") exercise its authority to forbear from regulating U S WEST as a dominant carrier in the provision of high capacity special access and dedicated transport for switched access in the Phoenix, Arizona Metropolitan Statistical Area ("MSA").

Section 10 of the Telecommunications Act of 1996 is a powerful regulatory tool which requires that the Commission remove needless regulation upon a showing of competition in a market. Despite this clear congressional mandate, a number of commenters attempt to introduce a host of irrelevant issues into this proceeding that have nothing whatsoever to do with the merits of U S WEST's Petition. The Commission should ignore these obvious attempts on the part of U S WEST's competitors to delay or sidetrack the granting of regulatory relief.

U S WEST presented extensive evidence in its Petition that the market for high capacity services (i.e., DS1 and above) in the Phoenix MSA is robustly competitive. No party opposing U S WEST's Petition presents any evidence to the contrary or raises any persuasive challenges to the evidence underlying U S WEST's Petition. Indeed, with few exceptions, opponents do not question the validity of U S WEST's market data -- only the meaning of it.

While opponents have conjured up numerous conflicting reasons why U S WEST's Petition has incorrectly defined the relevant product and geographic markets, they have a common objective -- the continued regulation of U S WEST as

a dominant carrier. There is no question that U S WEST's Petition is limited both in terms of product and geographic scope. But these are not artificial limitations, they are limitations that are dictated by the market.

Without evidence, opponents also assert that U S WEST continues to control the market for high capacity services in the Phoenix MSA. Although the opponents dispute the relevance of the retail market share, Alfred E. Kahn and Timothy J. Tardiff conclude that U S WEST's lack of direct contact with sophisticated retail buyers of high capacity services is very important to the question of whether it has market power. U S WEST's total market share also must be considered in the context of the share of new growth that competitive providers captured recently.

Further, no party has challenged U S WEST's evidence that the capacity of existing competitive networks is more than sufficient to absorb all of U S WEST's high capacity business many times over. Although two parties challenge POWER Engineers, Inc.'s ("PEI") estimate of build out costs, PEI refutes these vague and unsubstantiated criticisms. PEI also demonstrates that its estimated build out time would be significantly reduced if competitors focused on the large majority of U S WEST's customer locations located in close proximity to existing competitive fiber networks.

U S WEST's Petition satisfies the statutory criteria for forbearance. First, dominant carrier regulation of U S WEST's high capacity services in the Phoenix area is not necessary to ensure that rates and practices are just, reasonable and not unreasonably discriminatory. Several commenters resort to speculation about possible anti-competitive conduct which Kahn and Tardiff assert is simply inconceivable. In fact, Kahn and Tardiff demonstrate that U S WEST does not have the ability to cross-subsidize or engage in predatory pricing.

Second, dominant carrier regulation of U S WEST's high capacity services in the Phoenix area is not necessary to protect consumers. As with all other carriers, U S WEST will remain subject to Sections 201 and 202 of the Act.

Third, forbearance from applying dominant carrier regulation to U S WEST's high capacity services in the Phoenix area is consistent with the public interest. As the Commission has recognized, the regulation of incumbent LECs and new entrants should be symmetrical in a competitive environment. Kahn and Tardiff identify at least four types of costs imposed by continued dominant carrier regulation of U S WEST in a competitive environment and conclude that these regulatory burdens put U S WEST at a significant disadvantage in the market.

Ultimately, it is the customers who are harmed by the competitive distortions that result from continuing to regulate U S WEST as a dominant carrier in the Phoenix MSA market for high capacity services.

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U S WEST Communications, Inc. ("U S WEST") hereby submits its reply comments in support of its Petition requesting that the Federal Communications Commission ("Commission") exercise its authority to forbear from regulating U S WEST as a dominant carrier in the provision of high capacity special access and dedicated transport for switched access ("high capacity services") in the Phoenix, Arizona Metropolitan Statistical Area ("MSA").[1]

I. INTRODUCTION

Section 10 of the Telecommunications Act of 1996 is a landmark statutory provision in the history of telecommunications regulation. For the first time, Congress directed the Commission to remove needless regulation upon a showing of competition in a market. Fundamentally, Congress has made the affirmative decision that competition and market forces are superior to government regulation as a means of making decisions and maximizing consumer welfare.

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[1] Petition of U S WEST Communications, Inc. for Forbearance, filed Aug. 24, 1998. Public Notice, DA 98-1712, rel. Aug. 28, 1998; errata, DA 98-2019, rel. Oct. 6, 1998. Comments and oppositions filed Oct. 7, 1998.

Commissioner Michael Powell recently spoke eloquently about the importance of properly using the "powerful" tool of regulatory forbearance to build a competitive market:

> Properly viewed as a decision-making mechanism, it is plain to see that the market is a replacement for regulators making decisions about what services will be offered, what technology will be deployed, by whom, to whom, and at what price. A competitive market, thus, is NOT simply an accumulation of outcomes, pre-selected by the government. We should not yield to its forces only when those outcomes are achieved. . . .
>
> "Getting to competition," then, is not a construction project, as some in policy-making believe, and we are not its master-builders. Instead, I view the drill as handing off decision-making responsibilities to the market. Our work leading up to the change of command is to prepare our institutions for that change, and forbearance is one of the key levers we pull to execute the trade.[2]

Consistent with Powell's vision, U S WEST's Petition asks the Commission to pull the forbearance lever and allow competition to make decisions in the market.

Despite the clear congressional mandate of Section 10, opponents attempt to introduce a host of irrelevant issues that have nothing whatsoever to do with the merits of U S WEST's Petition. MCI WorldCom, Inc. ("MCI/MFS WorldCom"), for example, argues that U S WEST's Petition is "in many respects the functional equivalent of a waiver petition."[3] Starting from this false premise, MCI/MFS WorldCom proceeds to assert that "[i]t is well-established that an applicant for waiver faces a high hurdle even at the starting gate."[4] MCI/MFS WorldCom's feeble

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[2] Remarks (as prepared for delivery) by Commissioner Michael K. Powell before PCS '98, Sep. 23, 1998 at 3 (emphasis in original).

[3] MCI WorldCom at 22.

[4] Id.

attempt to transform a petition filed in accordance with the compulsory forbearance language of Section 10 into a mere waiver request does not warrant a response. Suffice it to say that the statutory criteria of Section 10 are not a "high hurdle" for petitioners, but rather a statutory command which requires the Commission to deregulate where there is a showing of competition.

Ironically, AT&T Corp. ("AT&T") argues that U S WEST should be denied regulatory relief in the Phoenix area market for high capacity services so that U S WEST will have an incentive to reduce prices for all access customers in all geographic areas.[5] This "all or nothing" approach to deregulation is at odds with AT&T's own experience in the long distance market. In particular, the Commission deregulated the business services segment of the long distance market when it found that AT&T faced sufficient competition for most business services,[6] even though the Commission also concluded that AT&T's 800 services, operator services, and international message telephone service were not yet sufficiently competitive to warrant streamlined regulation.[7] Refusing to deregulate those access markets, such as the Phoenix high capacity market, where competition has developed and been documented until it can be shown that all access markets are subject to a similar level of competition would be inconsistent with the Commission's precedent in the AT&T Nondominant proceeding, as well as the plain language of Section 10.

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[5] AT&T at 4.

[6] See In the Matter of Competition in the Interstate Interexchange Marketplace, Report and Order, 6 FCC Rcd. 5880, 5881-82 ¶¶ 8-9 (1991).

[7] Id. at 5905 ¶ 147, 5908 ¶ 165.

MCI/MFS WorldCom asserts that relief in Phoenix must be dealt with in the broader context of the Commission's access charge reform and pricing flexibility docket.[8] However, nothing in the statutory language of Section 10 gives the Commission the authority to delay granting regulatory relief to a petitioner in a competitive market while it addresses broader, industry-wide issues relating to access charges. To the contrary, Congress recognized the urgency of deregulating competitive markets and, therefore, established a one-year statutory deadline for issuing decisions on forbearance petitions. In any event, U S WEST's Petition is consistent with the Commission's parallel effort to implement pricing flexibility in the access market and should guide its decision-making in that proceeding. The Phoenix MSA market for high capacity services provides the Commission with a template for defining the characteristics of a fully competitive access market.

As U S WEST noted in its Petition, AT&T/TCG and MCI/MFS WorldCom are aggressive facilities-based direct competitors with U S WEST in the Phoenix area market for high capacity services.[9] Therefore, it is not surprising that these competitors have employed a variety of tactics in an attempt to delay or sidetrack the granting of regulatory relief. Their own business interests are best served if U S WEST remains handcuffed by regulation and unable to freely compete in the market. However, as the noted economists Alfred E. Kahn and Timothy J. Tardiff conclude, continuing to subject U S WEST to dominant carrier regulation harms customers by depriving them of the attractive prices and product offerings that

[8] MCI/MFS WorldCom at ii, 3, 26-27.

U S WEST could provide with the greater flexibility that would result from nondominant status.[10] The Commission should remain focused on the issues that are legitimately raised by U S WEST's Petition: whether the Phoenix MSA market for high capacity services is competitive and whether the public interest is served by regulating U S WEST in the same manner as all other competitors.

II. OPPONENTS DO NOT CHALLENGE THE VALIDITY OF U S WEST'S MARKET SHARE DATA -- ONLY THE MEANING OF IT

U S WEST presented extensive evidence in its Petition that the market for high capacity services (i.e., DS1 and above) in the Phoenix MSA is robustly competitive. Data compiled by Quality Strategies demonstrates that U S WEST's market share is declining in all sectors of the market and that U S WEST's retail market share is approximately thirty percent. Kahn and Tardiff analyzed Quality Strategies' data and Power Engineering's ("PEI") cost study and concluded that the Phoenix market for high capacity services fully satisfies the Commission's indicia of competition and that U S WEST lacks market power to impose anti-competitive prices or other conditions of service in this market.

In opposing U S WEST's Petition for Forbearance, no party presents any evidence to counter the compelling evidence contained in the Petition. Opponents appear to believe that it is sufficient to endlessly repeat the statement "U S WEST has market power" in the hopes that the Commission will accept this "mantra" in

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[9] Petition at 15-16.

[10] See Attachment A (Alfred E. Kahn and Timothy J. Tardiff, High Capacity Competition in Phoenix: Reply to Comments of Intervening Parties, at n.13, October 28, 1998 ("Kahn and Tardiff Reply")).

place of any contrary evidence. They are wrong. Neither the opponents nor the Commission can ignore the Phoenix market data or the thoughtful analysis of Kahn and Tardiff.

With few exceptions, opponents do not question the validity of U S WEST's market share data.[11] Opponents argue over the relevance of certain data in the Commission's forbearance determination and whether the appropriate geographical market is being analyzed; but they do not challenge the various market data that Quality Strategies compiled for the high capacity market in Phoenix. This is significant and should minimize the work effort involved in the Commission's forbearance determination. For example, the question now becomes what is the significance of a thirty percent retail market share, not what is the level of U S WEST's retail market share. A related question is whether a seventy-nine percent wholesale market share implies dominance regardless of U S WEST's share of the retail market. These questions must be considered in the context of the fifty percent share of new growth captured by competitive providers recently.

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[11] GST asserts that U S WEST's data is flawed in that it includes DS-0 circuits. (GST at 15.) U S WEST disagrees. As Quality Strategies explained in its report, it was not possible in collecting market share data to completely exclude DS-0 data from some market segments. Quality Strategies stated that the inclusion of such a small amount of DS-0 data (i.e., approximately 3%) would not appreciably affect market share data. (See Petition at Attachment A, Quality Strategies Report at 11.)

III. THE MARKET FOR HIGH CAPACITY SERVICES IN THE PHOENIX MSA IS THE RELEVANT MARKET FOR FORBEARANCE PURPOSES

Opponents have conjured up numerous conflicting arguments why U S WEST's Petition has incorrectly defined the relevant product and geographic markets. They assert that the Commission should not grant U S WEST's Petition for Forbearance because: (1) the geographic scope of the high capacity market is too limited;[12] (2) the geographic scope of the market is overly-broad;[13] (3) the "high capacity" product is too narrow;[14] (4) the high capacity product market is too broad;[15] and (5) U S WEST has market power in other product and geographical markets,[16] among other things. All of these arguments have a common objective -- the continued regulation of U S WEST as a dominant carrier. Clearly, it is in competitors' self-interest to oppose regulatory relief for U S WEST. Regardless of the lack of merit of these arguments, continued application of the Commission's dominant carrier rules to U S WEST's high capacity services provides competitors with a significant advantage in competing with U S WEST. The Commission should "level the playing field" in this forbearance proceeding.[17]

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[12] Sprint at 4; AT&T at 3.

[13] GST at 8-10; CompTel at 6; MCI/MFS WorldCom at 9.

[14] MCI/MFS WorldCom at 6; AT&T at 4-5; Sprint at 4.

[15] QWEST at 4.

[16] AT&T at 4.

[17] The importance of a level playing field to foster competition was recently recognized by AT&T's own chairman Michael Armstrong at the FCC's October 22, 1998 En Banc Hearing on Mergers. See summary of Armstrong's remarks (transcript of hearing not yet available according to FCC's Internet Homepage) in "Merger Partners Tell FCC That Deals Will Create Competition", Communications

There is no doubt that if U S WEST had selected a broader market in terms of both product and geography, critics would assert that U S WEST failed to provide specific evidence.[18] In preparing this Petition, U S WEST took Chairman Kennard's advice to heart when he "encourage[d] parties seeking future forbearance to submit specific showings and particularized evidence so that the Commission can analyze fully whether their requests satisfy each part of the test prescribed by Congress."[19] There is no question that U S WEST's Petition is limited in terms of product and geographic scope. But these are not artificial limitations, they are limitations that are dictated by the market.[20] In its Petition, U S WEST has provided particularized evidence about a specific market within a clearly defined geographic area, which should allow the Commission to make its determination in a minimal amount of time.

U S WEST continues to believe that the Phoenix MSA is the relevant geographic market for purposes of determining whether it is appropriate for the

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Daily, Oct. 23, 1998. As always, the goal should be to protect competition -- not competitors. Brunswick Corp. v. Pueblo Bowl-O-Mat, 429 U.S. 477, 488 (1977). Also, see Brown Shoe Co. v. United States, 370 U.S. 294, 320 (1962).

[18] See In the Matter of Southwestern Bell Telephone Company Tariff F.C.C. No. 73, Order Concluding Investigation and Denying Application for Review, 12 FCC Rcd. 19311, 19325 at ¶ 27 (1997) ("SWBT Tariff Order") (noting MCI's argument that, to obtain the relief it was seeking, Southwestern Bell had to "prove that competition exists within a defined geographic area").

[19] Order on PCIA Forbearance Petition, WT Docket No. 98-100, Separate Statement of Chairman Kennard, dated June 23, 1998, at 2 ("Statement of Kennard, PCIA Forbearance Order").

[20] As Kahn and Tardiff point out, "the fact that the relevant product market is narrower than the all-local-exchange-services definition proffered by some critics is

Commission to forbear from dominant carrier regulation of high capacity services. Kahn and Tardiff support this position.[21] The fact that competitors are not offering high capacity service throughout the Phoenix MSA on a ubiquitous basis is not a reason for finding that the Phoenix MSA market is too broad for forbearance purposes. Competitors are currently providing service to those parts of the Phoenix MSA which account for the vast majority of high capacity business and can easily expand to other parts of the Phoenix MSA if it is economically justified. As U S WEST's Petition notes, almost half of all U S WEST high capacity locations are within 1,000 feet of a competitive provider's backbone network.[22] In finding AT&T to be a nondominant provider of international services, the Commission concluded "that [the] high market shares [were] not an obstacle to granting AT&T's motion [for nondominance] in the absence of barriers to entry [that would] prevent AT&T's competitors from continuing to gain market share."[23] The same logic applies with respect to the outlying areas of the Phoenix MSA where U S WEST is the primary provider of what little high capacity service exists in these areas.

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richly illustrated by the market behavior of alternative access providers." See Kahn and Tardiff Reply at 2.

[21] Id. at 2. See also, Petition at Attachment C.

[22] These locations account for approximately 86% of all U S WEST's current high capacity demand in the Phoenix area.

[23] In the Matter of Motion of AT&T Corp. to be Declared Non-Dominant for International Service, Order, 11 FCC Rcd. 17963, 17978 ¶ 40 (1996). In making this finding, the Commission found that the countries in which AT&T had a very high market share accounted for less than 0.002% of AT&T's total billed minutes in 1994. Id. ¶¶ 94-97.

U S WEST also takes issue with those opponents who contend the Phoenix MSA is too limited and that the Commission should address these issues in a general access proceeding.[24] The Commission should reject such arguments as at odds with both the requirements of Section 10, as discussed above, and the Commission's desire that petitioners submit "specific showings and particularized evidence."[25] Broadening the geographic area to U S WEST's region surely would fail to satisfy the Commission's test of the relevant geographic market laid out in the Bell Atlantic/NYNEX Order.[26] As Kahn and Tardiff point out, U S WEST's market definition "follows closely the method employed by the antitrust authorities."[27] Furthermore, Section 10 does not give the Commission the discretion to decline to address U S WEST's Petition for the Phoenix MSA and to address similar competitive issues in an industry-wide access proceeding.

U S WEST's petition is narrowly tailored so that it covers only special access and dedicated transport for switched access at DS1 and higher transmission levels.[28] While opponents argue that U S WEST provides a larger share of DS1 service than DS3 service,[29] and that dedicated high capacity circuits used in the

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[24] MCI/MFS WorldCom at ii, 3; AT&T at 4; Sprint at 4.

[25] Statement of Kennard, PCIA Forbearance Order at 2.

[26] See 12 FCC Rcd. 19985, 20016-17 ¶ 54 (1997). The relevant geographic area is defined as "an area in which all customers in that area will likely face the same competitive alternatives for [relevant service]" (citation omitted).

[27] Kahn and Tardiff Reply at 2.

[28] U S WEST is not seeking relief for its xDSL series as alleged by Qwest. Qwest at 4.

[29] AT&T at 7; Sprint at 7; MCI/MFS WorldCom at 7-8.

provision of switched access differ from those used in the provision of special access,[30] they provide no evidence that these are separate markets or on the implied lack of substitutability between these services. There are no close demand substitutes for DS1 and above services[31] and, as such, the Commission should find that these services as a group constitute the relevant market for purposes of its forbearance analysis.

IV. OPPONENTS PROVIDE NO EVIDENCE THAT THE MARKET FOR HIGH CAPACITY SERVICES IN PHOENIX IS ANYTHING BUT ROBUSTLY COMPETITIVE

Without evidence, opponents assert that U S WEST continues to control the market for high capacity services in the Phoenix MSA. They contend that: 1) it is irrelevant for purposes of competitive analysis that U S WEST only has a thirty percent share of the retail market;[32] 2) market shares should be based on revenue, not volume of service;[33] 3) the Herfindal-Hirschman (HHI) indices demonstrate that the Phoenix high capacity market is highly concentrated and, therefore, U S WEST must have market power;[34] 4) U S WEST is able to exercise market power in the high capacity market through control of bottleneck facilities and long-term contracts; and 5) U S WEST has under-estimated both the cost and time for

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[30] MCI/MFS WorldCom at 7-8; GST at 15; Sprint at 7.

[31] In the Matter of COMSAT Corporation, File No. 60-SAT-ISP-97; IB Docket No. 98-60; File No. 14-SAT-ISP-97; RM-7913; CC Docket No. 80-634, Order and Notice of Proposed Rulemaking, ¶ 25, (citing LEC Classification Order, 12 FCC Rcd. 15756 ¶¶ 41, 54 (1997).

[32] GST at ii, 13; CompTel at 5.

[33] AT&T at 7; MCI at 19.

[34] Sprint at n.7; GST at 11.

competitors to build out their networks to serve additional buildings in the Phoenix area. Competitors include everything but the "kitchen sink" in their laundry list of arguments to support their joint proposition that U S WEST is a dominant provider of high capacity services and that Phoenix lacks competition. The only thing missing from these arguments is substantiating evidence.

As Kahn and Tardiff demonstrate, retail market share is very relevant to the question of whether U S WEST has market power. "The competitive significance of resellers is that in the presence of alternative suppliers of capacity, resellers can drive hard bargains on the price of that capacity.[35] This is particularly true when the resellers are the likes of AT&T, MCI/MFS WorldCom, and Sprint.[36] The combination of U S WEST's low retail market share, rapidly declining wholesale market share, and large sophisticated buyers such as the large IXCs, results in a market for high capacity services with a high demand elasticity. In such markets,

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[35] See Kahn and Tardiff Reply at 6.

[36] While AT&T chooses its words very carefully in hopes of giving the false impression that it is "dependent" on U S WEST and has no alternatives for high capacity services (e.g., "nearly 90% of AT&T's DS1 services are purchased from U S WEST" (AT&T at 7); "on a dollar-weighed basis, AT&T estimates that, as of September 1, 1998, U S WEST collects approximately 80% of the dollars that AT&T spends in the Phoenix LATA on high capacity services." (AT&T at 7-8)), AT&T's actions belie its words. AT&T cannot deny that it is in the midst of a massive project to move as much of its high capacity traffic as possible to TCG, its newly acquired affiliate. The fact that U S WEST still provides a relatively high share of AT&T's DS1 services is not an indication of U S WEST's market power but the fact that AT&T is still largely occupied with moving DS3 and higher services to TCG. Upon completion of this task, AT&T will turn its attention to moving its DS1 traffic to TCG. AT&T's behavior simply demonstrates that the demand for high capacity services in the Phoenix area is highly elastic.

even high market shares in some market segments are not indicative of market power.

On a related note, Sprint and GST contend that nondominant treatment is not appropriate for U S WEST because its overall market share (i.e., seventy-seven percent) results in an HHI index of approximately 6000.[37] This conclusion is unsupported. As Kahn and Tardiff point out:

> First, the antitrust authorities use the HHI as one indicator of whether to approve *mergers* that could lessen competition in an industry. They make no claim that the 1,800 cutoff point is a proper basis for deciding whether or not an industry should be regulated: on the contrary, they would unquestionably reject any such inference. Unregulated industries with HHI's well above 1,800 are far from uncommon. For example, the long-distance industry had an HHI of about 4,000 at the time the FCC granted nondominant status to AT&T. The unregulated central office equipment industry has a similar concentration. In the airline industry, HHIs are high in many markets, because a small number of carriers dominate; yet no serious commentator advocates reregulation of that industry.[38]

Kahn and Tardiff also note that if U S WEST's retail market share of thirty percent is used, it produces an HHI of 1,880, which is indicative of considerably less concentration than existed in the long distance industry when the Commission granted nondominant status to AT&T.[39]

Kahn and Tardiff also take issue with AT&T's and MCI/MFS WorldCom's assertions that U S WEST has incorrectly measured market share. AT&T and MCI

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[37] Sprint at n.7; GST at 11.

[38] Kahn and Tardiff Reply at 7-8.

[39] Id. at 8. Furthermore, HHI alone does not address the existence of market power. Market power is the power to affect price and output. U S WEST does not have market power for high capacity services in the Phoenix MSA because any competitive provider is free to enter the market, and U S WEST's prices currently are regulated.

contend that market share should be calculated based on revenues rather than capacity. Kahn and Tardiff support U S WEST's use of a capacity measure. They note that "[i]n the present instance, involving sales to typically well-informed buyers, it seems unlikely that product differentiation would be determinative: modern telecommunications networks are distinguished most fundamentally by their physical ability to transmit information."[40] They also point out that using current output (i.e., DS1 equivalents) to calculate market share and not including the total capacity of U S WEST's competitors understates the competitive significance of other providers of high capacity service on Phoenix.[41] Thus, rather than understating market share as AT&T and MCI/MFS WorldCom contend, the data in U S WEST's petition seriously overstates U S WEST's market share.

Opponents contend that demand elasticity is limited by U S WEST's control of bottleneck facilities and the fact that U S WEST often provides high capacity services under term agreements.[42] There is no basis for these claims.[43] The existence of numerous CAP/CLEC networks in Phoenix and their close proximity to U S WEST's customers for high capacity services have eliminated whatever bottleneck might have existed in the past for special access services.[44] For dedicated

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[40] Kahn and Tardiff Reply at 5.

[41] Id. at 5.

[42] MCI at 9-10; CompTel at 5; Sprint at 2.

[43] See also, Kahn and Tardiff Reply at note 12 for a discussion of bottleneck control.

[44] Special access and private line are point-to-point nonswitched services. They connect a carrier's point of presence ("POP") to an end user location. They can also be used to connect POPs. Both of these applications are commonly known as special access. These same services are used to connect two or more end user locations, this

transport which is used in the provision of switched access, the situation is somewhat different,[45] but it is a "far cry" from MCI's self-serving, misleading contentions.[46] In order to effectively compete for high capacity services used in the provision of switched access transport, competitors need to be collocated in U S WEST's central offices. Currently, CAPs are collocated in 15 of the 65 central offices in the Phoenix MSA. These central offices account for forty-nine percent of U S WEST's access lines in Phoenix.[47] The fact that MCI has only chosen to collocate in two of these central offices in no way diminishes the competition that U S WEST faces in the provision of switched access transport.

In a similar vein, MCI also grossly mischaracterizes the status of high capacity services subject to term agreements.[48] Currently, approximately twelve

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application is known as private line. Competitors can easily provision any of these applications. They do not need collocation in a U S WEST central office to offer a complete line of competitive alternatives.

[45] Switched access transport is the facility which U S WEST dedicates to an interexchange carrier to deliver the switched access traffic to that carrier's POP from either the end office or the tandem serving the end user. Competition for switched access transport can happen in two ways. First, the carrier (or the competitor) creates a "closet POP" which minimizes the distance U S WEST has to transport the traffic. A competitor transports the traffic from the closet POP, using its facilities, to the POP of the carrier. Second, U S WEST delivers the traffic to collocation space in a U S WEST central office. The competitor transports the traffic to the carrier's POP.

[46] MCI/MFS WorldCom asserts that "[o]f approximately 70 central offices in the Phoenix MSA, only 2 have operational CAP collocations." MCI/MFS WorldCom at 11.

[47] Three additional central offices provide collocation space to CLECs for local interconnection purposes (i.e., the purchase of unbundled loops). In total, these 18 central offices serve 60% of U S WEST's access lines in the Phoenix MSA.

[48] MCI/MFS WorldCom at 9-10.

percent of U S WEST's switched access transport revenues are subject to term agreements while approximately seventy percent of its high capacity special access service revenues are subject to such agreements. Approximately half of these agreements will expire within two years, two-thirds will expire within three years, and over ninety-five percent will expire within five years.[49] Clearly, term agreements do not present a barrier to competition, particularly in a fast-growing market such as the Phoenix MSA.[50]

Another major aspect of the Commission's nondominant inquiry is whether the supply of high capacity services is elastic or inelastic. This inquiry should focus on the ability of competitors to expand to serve U S WEST's customers in Phoenix. As U S WEST noted in its Petition, elasticity of supply is determined both by the amount of unused capacity in competitors' existing networks and their ability to build out their networks to additional locations within a reasonable amount of time.[51]

No party has challenged U S WEST's evidence that the capacity of existing competitive networks is more than sufficient to absorb all of U S WEST's high capacity business many times over. Only MCI/MFS WorldCom and AT&T

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[49] Over half of these agreements have very liberal termination penalties which only require the payment of a 15% termination liability after the first year of service. It should come as no surprise that many competitors agree to reimburse new customers for any termination liability incurred in switching service from U S WEST.

[50] Recent expansion of competitive providers' business has been even more rapid than the impressive 13% growth in demand for high capacity services in the Phoenix area market.

[51] Petition at 25-31.

challenge U S WEST's estimate of build out costs.[52] They argue that PEI has under-estimated both the cost and the time to connect additional buildings to competitive networks. MCI/MFS WorldCom feebly attempts to support its arguments by claiming that PEI has failed to include certain critical cost elements and that MCI/MFS WorldCom spends about four times as much as PEI's estimates to connect buildings to its network.[53] Mr. William R. Kopp of PEI disagrees with MCI/MFS WorldCom's assertions and states that PEI's cost study fulfilled its objective of "provid[ing] a reasonable estimate of the 'broad-gauge' costs of constructing connections to a large number of locations."[54] Mr. Kopp notes that PEI's study never was intended to be suitable for "site-specific costs."[55] Mr. Kopp also refutes MCI/MFS WorldCom's contention that PEI failed to include certain costs. Mr. Kopp reiterates that PEI's study "estimates the cost of a large scale build out to extend CAP facilities to duplicate the service level currently provided by U S WEST." In addressing the issue of build out time, Mr. Kopp states that "Power's time estimates were based, [however], on a major construction program in which loops to existing U S WEST locations would be built in the course of a single coordinated effort," rather than on an individual location basis.[56] Mr. Kopp also notes that since a large percentage of U S WEST's high capacity locations are within a 1000 feet and many

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[52] MCI at 12-13; AT&T at 10-11.

[53] MCI/MFS WorldCom 12-13.

[54] Attachment B at 1.

[55] Id.

[56] Id.

within 100 feet of CAP networks, the build time would be significantly less than PEI's estimates if competitors focused on these close-in locations.[57]

V. U S WEST'S PETITION SATISFIES THE STATUTORY CRITERIA FOR FORBEARANCE

U S WEST's Petition, which is supported by a marketing study, an engineering report and an economic analysis, clearly satisfies the three statutory criteria for forbearance. In fact, it contains precisely the type of specific showing and particularized evidence called for by Chairman Kennard so that the Commission can verify that a forbearance request satisfies each part of the test prescribed by Congress.[58] The commenters opposing U S WEST's Petition have presented no evidence to the contrary.

First, dominant carrier regulation of U S WEST's high capacity services in the Phoenix MSA is not necessary to ensure that rates and practices are just, reasonable and not unreasonably discriminatory. With one exception, the commenters do not even allege any actual anti-competitive behavior on the part of U S WEST.[59] Rather, several commenters resort to speculation about possible anti-

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[57] Id.

[58] See Statement of Kennard, PCIA Forbearance Order at 2.

[59] TSR Wireless LLC ("TSR"), a one-way paging provider, claims that U S WEST's rates and practices with respect to TSR are unreasonable and discriminatory because U S WEST has refused to provide it with free dedicated T1 facilities. TSR Opposition at 5. The facilities that TSR is referring to are not used to provide interstate special access or dedicated transport for switched access and thus do not fall within the scope of U S WEST's forbearance request. In addition, as TSR acknowledges, the matter is the subject of a pending complaint proceeding as well as a broader proceeding regarding LEC-paging interconnection at the Commission. TSR Opposition at 5-6. For these reasons, the parties' disagreement has no relevance to U S WEST's forbearance Petition.

competitive conduct (i.e., cross-subsidization and predatory pricing) which Kahn and Tardiff assert is "simply inconceivable" given the continued regulation of other services and the presence of competition for high capacity services.[60]

Kahn and Tardiff demonstrate that U S WEST does not have the ability to cross-subsidize prices for high capacity services. Although nondominant regulation of high capacity services in Phoenix could allow U S WEST to raise those prices, it cannot then lower those same prices to predatory levels without losing money.[61] In addition, U S WEST has no unilateral authority to raise prices regulated at the state level.[62]

Moreover, the concern raised by some commenters about the potential for reduced rates in the Phoenix area to produce higher rates in other geographic areas under price caps is unfounded. As GST acknowledges, the Commission established a price cap regime in order to forestall cross-subsidization of unregulated service through increases in regulated services.[63] U S WEST will be removing both the actual demand and corresponding revenue for services subject to nondominant treatment in the Phoenix MSA in such a way as to eliminate any impact on the price of services which remain under price cap regulation. Thus, U S WEST will gain no upward pricing ability or downward pressure for the services that remain under price cap regulation.

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[60] Kahn and Tardiff Reply at 1.

[61] Id. at 12.

[62] Id.

With respect to predatory pricing, the "crucial question" is whether such pricing could drive competitors out of the market for a period that would be sufficient to allow U S WEST to recoup its losses.[64] Kahn and Tardiff believe that it is "extremely unlikely" predation could be successful in this case.[65] The five facilities-based competitive providers in Phoenix already have a great deal of installed capacity. Even if U S WEST were able to drive out such unlikely targets for successful predation as AT&T, it would not drive out the facilities that have been installed. Because extensive competitive fiber networks are already in place, some firm would find it economical to resume operating them in competition with U S WEST.[66]

Those commenters who raise speculative concerns about anti-competitive conduct also mischaracterize the nature of the relief being sought. U S WEST is not requesting that its high capacity services be totally deregulated -- it is seeking only to be regulated as a nondominant carrier in the Phoenix area market for high capacity services. Regulating U S WEST as a nondominant carrier will have no

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[63] GST Opposition at 21 (citing United States v. Western Elec. Co., 993 F.2d 1572, 1580-81 (D.C. Cir.), cert. denied, 510 U.S. 984 (1993)).

[64] Kahn and Tardiff Reply at 12.

[65] Id. at 12.

[66] Id. at 13. Kahn and Tardiff conclude "emphatically that it would be simply impossible" for U S WEST to engage in the type of predatory pricing responses to competitive entry that may be occurring in the airline industry. The fundamental difference between the two situations is that incumbent airlines have the ability to temporarily increase their capacity on challenged routes and by so doing force new entrants to pull their equipment out, whereas once new entrants install fiber optic facilities, these costs are sunk and the marginal costs are only a small fraction of their total costs. Kahn and Tardiff Reply at n.4.

effect on U S WEST's obligations to comply with Section 251(c) of the Act.[67] Nor will it give U S WEST any ability to provide interLATA services that are currently prohibited by Section 271 of the Act.[68] U S WEST is not asking (and indeed could not ask) the Commission to forbear from applying the requirements of Sections 251(c) and 271.[69] Thus, there is no legitimate reason for raising these statutory provisions in connection with U S WEST's Petition.

Second, dominant carrier regulation of U S WEST's high capacity services in the Phoenix MSA is not necessary to protect consumers. MCI/MFS WorldCom claims that, absent regulation, U S WEST would have the ability to "increase prices and distort competition in the interexchange market."[70] This unsupported claim is refuted by the finding of Kahn and Tardiff that competition itself, without dominant firm regulation, is sufficient to restrain U S WEST's ability to impose anti-competitive prices and other conditions.[71] Moreover, MCI ignores the fact that, as with all other carriers, U S WEST will remain subject to Sections 201 and 202 of the Act. The Commission can continue to address any issue of unlawful rates or practices through the exercise of its authority to investigate and adjudicate complaints under Section 208.

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[67] CompTel Opposition at 9.

[68] GST Opposition at 13 n.43. GST subsequently acknowledges that, even if U S WEST is declared nondominant for high capacity services, it still will be at a marketing disadvantage because it will be unable to provide in-region interLATA services. Id. at 14.

[69] 47 U.S.C. § 160(d).

[70] MCI/MFS WorldCom Opposition at 24.

[71] Kahn and Tardiff Reply at 14.

Third, forbearance from applying dominant carrier regulation to U S WEST's high capacity services in the Phoenix MSA is consistent with the public interest. As the Commission has recognized, the regulation of incumbent LECs and new entrants should be symmetrical in a competitive environment.[72] The current asymmetrical regulation of U S WEST in the intensely competitive environment of the Phoenix area market for high capacity services is extremely harmful to the public interest because it deprives consumers of the benefits of new products and services.

AT&T and MCI/MFS WorldCom attempt to downplay the extent to which U S WEST is handcuffed by dominant carrier regulation.[73] However, there simply is no comparison between the limited regulatory relief afforded by density zone pricing and the broad regulatory freedom enjoyed by nondominant carriers. Kahn and Tardiff make the point that "there are competitive benefits from nondominant status that go well beyond pricing flexibility."[74] Kahn and Tardiff also identify at least four types of costs imposed by continued dominant carrier regulation of U S WEST in a competitive environment: (1) the tariff notice period dampens U S WEST's incentive to innovate by allowing competitors to respond to its innovations before they are actually offered; (2) the same notice period dampens U S WEST's incentive to reduce prices; (3) U S WEST's competitors can take advantage of the asymmetrical regulatory process to delay and undermine its

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[72] SWBT Tariff Order, 12 FCC Rcd. at 19337 ¶ 53.

[73] AT&T at 14; MCI/MFS WorldCom at 26.

[74] Kahn and Tardiff Reply at n.13.

initiatives; and (4) regulation imposes administrative costs on both U S WEST and the Commission.[75] At a time when competitors such as AT&T/TCG and MCI/MFS WorldCom are expanding their product offerings to include bundles of services, these regulatory burdens put U S WEST at a significant disadvantage in the market.

Ultimately, it is the customers who are harmed by the competitive distortions that result from continuing to regulate U S WEST as a dominant carrier in the Phoenix MSA market for high capacity services. One such result is "umbrella" pricing, where competitors challenge U S WEST's proposed tariff rates for being unlawfully low while pricing their own services below U S WEST's tariffed rates. Forbearance of the dominant carrier tariff filing requirement would foster true competition in the market by increasing the incentive of all competitors to introduce competitive prices and innovative services. The end result is increased choice for customers.

The Commission itself has recognized that competition, not regulation, is the optimal means of maximizing the public interest. In adopting a market-based approach to access charge restructure, the Commission recognized,

> Competitive markets are superior mechanisms for protecting consumers by ensuring that goods and services are provided to consumers in the most efficient manner possible and at prices that reflect the cost of production. <u>Accordingly, where competition develops, it should be relied upon as much as possible to protect consumers and the public interest.</u> In addition, using a market-based approach should minimize the potential that regulation will create and

[75] <u>Id.</u> at 14.

> maintain distortions in the investment decisions of competitors as they enter local telecommunications markets.[76]

Fundamentally, Section 10 codifies a market-based approach by requiring that, where competition exists, the Commission must remove unnecessary government regulation.

VI. CONCLUSION

Section 10 reflects Congress's reasoned judgment that competition, not government regulation, is the optimal decision-making mechanism in the marketplace. A number of commenters completely miss the mark and treat forbearance as if it is a carrot to be dangled in front of U S WEST or a reward that must be dribbled out slowly over a number of years. That is not what Congress intended. Section 10 is, in fact, a powerful regulatory tool which requires the substitution of market forces for government regulation where there is competition.

U S WEST's Petition asks the Commission to pull the lever of forbearance and rely on competition to maximize the public interest. In support of its Petition, U S WEST's has submitted irrefutable evidence that the Phoenix MSA market for high capacity services is intensely competitive and, therefore, U S WEST does not have the ability to exercise market power. The Petition also satisfies the criteria of Section 10. For these reasons, the Commission should act expeditiously to grant

[76] In the Matter of Access Charge Reform, 12 RCC Rcd. 15982, 16094 ¶ 263 (1997) (emphasis added).

U S WEST regulatory relief from dominant carrier regulation in the Phoenix MSA market for high capacity services.

Respectfully submitted,

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ATTACHMENT A

HIGH CAPACITY COMPETITION IN PHOENIX: REPLY TO COMMENTS OF INTERVENING PARTIES

Alfred E. Kahn and Timothy J. Tardiff

October 28, 1998

I. INTRODUCTION

Several parties, for the most part U S WEST's competitors in the sale of high capacity services, have protested the Company's request for non-dominant status. They argue that U S WEST continues to enjoy market power, and for this reason has not met the requirements of Section 10 of the Telecommunications Act of 1996. Their conclusions are based upon (1) an overly broad definition of the relevant market, the effect of which is to minimize the competitive inroads into it; (2) understatement of the size of competitors; (3) minimizing the elasticity of demand—specifically, the ease with which customers can (and do) change suppliers; (4) understating the elasticity of competitive supply—the ability of competitors to expand operations; and (5) speculations about anti-competitive conduct (cross-subsidy and predatory pricing) that is simply inconceivable in the face of the continued regulation of other services and the presence of the competition for high capacity services we identified in our opening paper.

Significantly, no party has provided information that contradicts the basic facts we presented. For example, parties have either accepted the market share information we relied upon or offered data that corroborate it.[1] Other purportedly contradictory information that they did present is itself contradicted by their statements elsewhere and/or by their own actions in the market place. For example, both AT&T and MCI Worldcom complain in imprecise terms

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[1] AT&T reports that 20 percent of the dollars it spends to acquire high capacity services from others go to U S WEST's competitors. As other commenters have pointed out, the share of expenditures for competitors' services will be lower than their corresponding share of sales volumes (e.g., DS-1 equivalents). Therefore, AT&T's reported 20 percent figure tends to corroborate the Quality Strategies' estimated 23 percent share of sales volumes secured by those competitors.

about the difficulty new entrants face in attracting new customers and in expanding their networks to reach new locations. If the world really were so hostile, one wonders why both firms have spent tens of billions of dollars to acquire firms that have given them a presence in Phoenix and other major cities. While entry into these markets is no doubt challenging, the actions of firms like AT&T and MCI and the growing competition that they have produced speak much more loudly than their advocacy in regulatory proceedings of continued restrictions on one of their major competitors.

II. Market Definition

Parties commenting on our definition of the relevant market as confined to high capacity facilities in the Phoenix metropolitan area have suggested that the product market is larger (embracing all local exchange services) and that the geographic market may be smaller (specific point-to-point routes). They have offered no specific criticism of our market definition process, which, as we pointed out in our opening paper, follows closely the method employed by the antitrust authorities. Specifically, our definition of the product market is dictated by the lack of demand response by customers of low- and high-capacity facilities, respectively, to changes in the prices of the other: none of the comments directly contradicts our reasoning on this point, which we would in any event have regarded as self-evident. Our definition of the geographic scope of the market was a practical one, based on the observed entry patterns of competitive carriers.

The fact that the relevant product market is narrower than the all-local-exchange-services definition proffered by some critics is richly illustrated by the market behavior of alternative access providers. For example, according to AT&T's press release issued upon completion of its recent acquisition of Teleport Communications, which greatly strengthened its market position in the offer of exchange access services in Phoenix and elsewhere:

> 'Completion of this merger accelerates our entry into the $21 billion *business* local service market because we're reducing our dependence on the Bell Companies for direct connections to businesses,' said AT&T Chairman C. Michael Armstrong. ... 'We're giving customers simplicity, convenience and

> choice. It's one-stop shopping for local and long-distance service, just for starters,' he said.[2]

Manifestly AT&T views business local services as separate from residential.[3] Since TCG's high-capacity fiber optic network is clearly capable of supplying both "low-capacity" and high-capacity services to that business market, our further delimitation of the relevant market in this case confining it to these latter services was justified not on supply-side considerations but on the non-substitutability of low- and high-capacity services, our exposition of which none of the responders has contradicted.

The incorrect broader market definition proffered by opposing parties would have the effect of inhibiting U S WEST's response to the strong competition of which AT&T itself boasts and which other providers are also offering in Phoenix. While such restrictions would undoubtedly protect AT&T and the others, they would deprive customers of the attractive prices and services that U S WEST would be able to offer if it were accorded the greater flexibility of non-dominant status.[4]

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[2] "AT&T Completes TCG Merger; TCG Now Core of AT&T Local Services Network Unit," AT&T News Release, July 23, 1998, emphasis added. The Release went on to describe how the TCG acquisition facilitates its offer of Digital Link service, an arrangement that employs high capacity links to business customers.

[3] Similarly, MCI WorldCom, following approval of its merger, recently announced a marketing initiative that targets offerings to *business* customers that combine local, long-distance, voice, and data services for calls on its network. "MCI WorldCom Sets Major Marketing Plan for Business Clients," *Wall Street Journal*, September 29, 1998.

[4] One of us has, especially in recent months, strongly propounded the view that some of the responses by incumbent airlines to competitive entry may well have been predatory in both intent and effect. Kahn, "Comments on Exclusionary Airline Pricing," Submission to the Department of Transportation, September 25, 1998. We have therefore explicitly considered the question of whether, if accorded non-dominant status, U S WEST could successfully engage in the same sort of tactic in response to entry by firms such as AT&T and MCI WorldCom—sufficiently to conclude emphatically that it would be simply impossible. It should suffice to demonstrate the fundamental difference between the two situations to point out the vast difference between the resources of incumbent airlines and their upstart challengers—in contrast with the far closer to parity of U S WEST and its major local challengers; and, in a sense even more fundamental, the ability of incumbent airlines greatly to increase their capacity on the challenged routes, temporarily, and by so doing to force the entrants to pull their equipment out, whereas—as we will point out below—the fiber optic facilities of the new entrants in the provision of high capacity service, once installed, are sunk, with marginal costs only a small fraction of their total costs.

III. COMPETITORS HAVE CAPTURED A COMPETITIVELY SIGNIFICANT SHARE OF THE HIGH CAPACITY MARKET

While offering no serious rebuttal to our estimate of the presence and size of alternative high capacity providers in Phoenix, the intervening parties offer different interpretations of the basic facts with the intent of minimizing them. These misleading interpretations include: (1) the argument that market shares should be based on revenues, rather than volumes; (2) the dismissal of U S WEST's small share of the retail market as having any competitive significance; and (3) the presentation of Herfindahl-Hirschman (HHI) indices in an attempt to demonstrate that the Phoenix high capacity market is excessively concentrated.

In addition to their attempt to introduce misleading estimates of the current *level* of competitive presence, they are silent on the rapid *growth* in the market share of U S WEST's competitors. As we pointed out in our opening paper, the CLECs in Phoenix have captured about half of the growth in the rapidly expanding high capacity market.[5] The rapidity of this growth and the CLECs' ability to capture so large a share of it are of greater competitive significance than any static measures of their market share.

A. Measuring Market Shares: Dollar Sales or Physical Volume?

Turning first to the proper basis for calculating market share, the objective in any such calculation is to measure the competitive significance of the smaller firms. In contrast with the critics of U S WEST's previous contentions, Landes and Posner present a compelling case for assessing the competitive significance of challengers by taking into account not just their actual output but their *total physical capacity*:

> ...the sum of the capacity, or potential output, of competitors and the current output of the firm in question should be the denominator in computing the firm's market share. The greater the difference between capacity and current output, the greater is the supply elasticity of competing firms, and therefore the greater

[5] Thus, Sprint's supposition that the high capacity market will contract and firms will exit is grossly inconsistent with recent history and the strong growth of CLECs that we discussed in our opening paper.

is the constraint that these firms place on a firm that tries to raise price above marginal cost.[6]

The *Horizontal Merger Guidelines* set forth the respective bases for using dollar sales or physical sales:

> Market shares will be calculated using the best indicator of firms' future competitive significance. Dollar sales or shipments generally will be used if firms are distinguished primarily by differentiation of their products. Unit sales generally will be used if firms are distinguished primarily on the basis of their relative advantages in serving different buyers or groups of buyers. Physical capacity or reserves generally will be used if it is these measures that most effectively distinguish firms.[7]

In the present instance, involving sales to typically well-informed buyers, it seems unlikely that product differentiation would be determinative: modern telecommunications networks are distinguished most fundamentally by their physical ability to transmit information. The newer entrants may emphasize lower-priced uses of capacity as an entry strategy. As they become established, however, their full capacity would be available to compete against the incumbent and the other entrants. The implication of these several considerations, we suggest, is that, if anything, our use of market shares defined in terms of current sales, in physical units, without taking into account the *capacity* of the competing providers of high-capacity service in Phoenix, understated their competitive significance.[8]

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[6] William M. Landes and Richard A. Posner, "Market Power in Antitrust Cases," *Harvard Law Review*, Vol. 94, 1981, p. 949.

[7] US Department of Justice and Federal Trade Commission, *Horizontal Merger Guidelines*, April 2, 1992, Section 1.41.

[8] Recall that our measure assigned a share of 77 percent of DS-1 equivalents to U S WEST. Landes and Posner (*ibid.*, p. 950) discuss an example in which a firm with 80 percent share lacked market power. In that case, (1) over the previous decade, the firm's share had fallen from 100 percent to 80 percent and (2) further entry and expansion is relatively easy. As our opening paper demonstrated, these characteristics are exhibited likewise by the high capacity market in Phoenix. The reasoning of Landes and Posner would therefore justify the conclusion that U S WEST lacks market power in the sale of these services.

B. Measuring Market Shares. Retail or Wholesale?

In our opening paper, we emphasized U S WEST's shrunken share of the retail market–now under 30 percent. As we pointed out, the competitive significance of this dramatic decline is by no means confined to competition in the sale of high-capacity services alone: the manifest success of U S WEST's competitors in attracting customers for those services clearly foreshadows their probable success in offering the complete range of retail services, combining local, long-distance, voice and data traffic in one package. Moreover, once a competitor such as AT&T and MCI WorldCom captures an end-use customer, it has strong incentives to shift traffic from ILEC facilities to its own network, as we discuss in more detail below. In contrast, intervening parties, primarily the three interexchange carriers (AT&T, MCI, and Sprint), criticize U S WEST's citation of its 30 percent of the retail market as having minimal competitive significance. Their downplaying the critical importance of direct contact with sophisticated retail buyers ignores several critical economic facts that we discussed in our opening paper and review here:

- In its non-dominance proceedings, AT&T's own consultants argued that the 12 percent share of resellers in the long-distance business was sufficient to constrain the pricing behavior of the major IXCs, who collectively held the other 88 percent. The FCC agreed with them. These are the very same IXCs that denigrate the importance of resale in the present case. The competitive significance of resellers is that in the presence of alternative suppliers of capacity, resellers can drive hard bargains on the price of that capacity.

- High capacity buyers are sophisticated business consumers and their retail suppliers, with 70 percent of that retail business, have a growing number of alternative sources of the high capacity inputs they require. Once a retail supplier has attracted a base of customers, it can relatively easily shift its purchases among alternative suppliers of capacity: that is what makes it possible for it to drive hard bargains even in dealing with suppliers that own the major share of the underlying capacity. This bargaining power is of course enhanced by the ability of such successful retailers to construct their own underlying facilities. The very rationale for acquiring Teleport that AT&T described in the press release from which we have just quoted was to offer its sophisticated customers "one-stop shopping" and to lessen dependence on Bell companies in supplying these services and facilities. There can be no doubt, for example, that AT&T's ability to divert market share at the wholesale level from U S WEST to high capacity facilities formerly owned by Teleport is substantially enhanced by its offer of long-distance (e.g., MEGACOM) and local (Digital Link) services that employ high capacity access. Similarly, MCI WorldCom has clearly stated its intention to migrate access traffic from ILEC networks to its own combined network:

> Part of the rationale for WorldCom's acquiring MCI was that the combined company could meld its networks to create a seamless system for global communications. The largest expense for MCI, as a long-distance carrier, had been fees paid to local phone companies for beginning and ending calls.
>
> MCI WorldCom now wants essentially to eliminate those fees for business customers who use the company for local and long-distance calling. For a conversation or data message that travels exclusively on MCI WorldCom's network, rates could decrease by as much as 35 percent, the company said.[9]

C. Incorrect Applications of HHI Indices

Sprint and GST calculate an HHI index of about 6,000 based on U S WEST's reported share of 77 percent of high capacity volume.[10] Because this result is higher than the value of 1,800 designated by the *Merger Guidelines* as denoting a highly concentrated industry, these parties conclude that non-dominant treatment is not appropriate. Their calculation does not support this conclusion for a number of reasons.

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[9] Seth Schiesel, "FCC Blocks Two Bells on Long-Distance Entry," *The New York Times, September 29, 1998.*

[10] The HHI index is the sum of the squares of the shares of the firms in the market in question. For example, if two firms split a market, the resulting HHI would be 5,000 ($50^2 + 50^2$).

First, the antitrust authorities use the HHI as one indicator of whether to approve *mergers* that could lessen competition in an industry. They make no claim that the 1,800 cutoff point is a proper basis for deciding whether or not an industry should be regulated: on the contrary, they would unquestionably reject any such inference. Unregulated industries with HHI's well above 1,800 are far from uncommon. For example, the long-distance industry had an HHI of about 4,000 at the time the FCC granted nondominant status to AT&T. The unregulated central office equipment industry has a similar concentration. In the airline industry, HHIs are high in many markets, because a small number of carriers dominate; yet no serious commentator advocates reregulation of that industry.

Second, as we have already pointed out, our market share estimate, which is based on DS-1 equivalent sales, understates the competitive significance of CLECs, which would, according to the logic expounded by Landes and Posner, take into account their total capacity. Such a measure would reduce U S WEST's share and the associated HHI.

Third, the HHI for *retail sales* is much much smaller. A market share of 30 percent for U S WEST produces an HHI of 1,880, under the assumption that the remaining 70 percent of the market is evenly distributed over the five competing CLECs. This 1880 figure is of course substantially less than half that of the long-distance market at the time when AT&T requested and the FCC granted it non-dominant status.

IV. ABILITY OF COMPETITIVE SUPPLIERS TO EXPAND

The FCC's previous analysis of nondominant status appraised three separate indicia of the ability of competitors to expand: (1) demand elasticity, (2) supply elasticity, and (3) cost structure and financial capabilities of those competing firms. We made each of these appraisals of the high-capacity market in our opening paper, demonstrating that customers are indeed willing to shift suppliers and that competitors in Phoenix have sufficient ability to meet their demands; and we therefore concluded that this existing and growing competition sufficiently disciplines U S WEST's ability to price anticompetitively as to deprive it of market power in the sale of these services.

In response, the intervening parties suggest specific impediments to competition: (1) long-term contracts, (2) expansion costs higher than those estimated by PEI, and (3) the relatively small size of particular competitors. Our general response is that the opposing parties have generally offered no guidance whatever about the importance and magnitude of the first asserted impediment, and market developments clearly demonstrate that these several asserted factors have not in fact proved to be major barriers to healthy expansion of competition.

With regard to the first asserted barrier, U S WEST estimates that only about 12 percent of its high capacity Switched Access Transport revenues are subject to term agreements, and while approximately 70 percent of its high capacity Special Access service revenues are subject to such agreements, approximately half of these will expire within two years, two-thirds within three years and over 95 percent within five years. The first, 12 percent share is less than the growth in the market in a single year: the other 88 percent is purchased on a monthly basis and therefore up for competitive grabs. As for the Special Access market, and entirely apart from the possibility of inducing customers to cancel their contracts, there is clearly a rough synchronization of the rates at which contracts expire and competitors can construct facilities. The facts that we cited in our opening paper provide powerful testimony to the fact that, despite the (typically short-term) contracts, competitors *are* enjoying a rapidly increasing share in a rapidly growing market. Indeed, we observed, (1) new entrants are capturing about half of the new demand and (2) they have already captured 70 percent of the retail market. No responding parties have offered any information that contradicts these figures. In fact, their actions corroborate our conclusions: we have already cited AT&T's own proclamation that its acquisition of Teleport earlier this year reflected its own expectations that it would by this acquisition be enabled to offer very attractive products to business customers and to be able to shift the provisioning of its requirements from facilities of the Bell Companies.

The supply elasticity story is similar.[11] In spite of the specific obstacles cited by the intervening parties—e.g., gaining access to buildings—the fact remains that CLECs are attracting capital and are expanding at a rapid rate. Clearly, the particular obstacles cited by these intervenors have not deterred either investors or their own managements from providing the funds to expand operations. Again, AT&T's words at the completion of its acquisition of Teleport provide some real-world market perspective on this issue:

> TCG has more fiber route miles and serves more businesses in more cities than any other competitive local service company," Armstrong said. "The strategic value of this merger...positions AT&T for growth and undisputed leadership in three of the fastest growing segments of the communications services industry–consumer, business and wholesale networking services.
>
> TCG, with more than 10,000 miles of fiber optic cable and 50 local switches, is the nation's premier provider of competitive communications services. Its network encompasses more than 300 communities coast to coast. Armstrong said that AT&T also pledges to devote substantial resources to continue the building of facilities in critical markets.

The most detailed discussion of the cost structure and financial capability of competing carriers was provided by GST, the burden of whose comments was that it is much much smaller than U S WEST, as indeed it is. This fact alone has no competitive significance, however: what is relevant is the *combined* capabilities of existing and potential CLECs in Phoenix and their ability to expand their capacities as a group. Paradoxically, GST's figures confirm U S WEST's response to that centrally significant question. For example, GST reports that the combined mileage of its fiber routes alone amounts to only 10 percent of the mileage of U S WEST. Since GST has the smallest network of the CLECs in Phoenix, the combined route coverage of the five CLECs taken together manifestly adds up to a very large fraction of U S WEST's capacity and route miles.

More important are the prospects for growth of existing carriers and new entry. As we discussed in our opening paper, the CLECs are expanding rapidly and having no trouble

[11] MCI WorldCom claimed, without documentation, that its cost of expanding to meet new demand are considerably higher than PEI's estimates. PEI's reply declaration explains why its original cost estimates are reasonable.

attracting capital to fund further expansion. Moreover, even a relatively small firm can exert competitive discipline on a much larger rival. For example, in 1988, Compaq generated only 3 percent of IBM sales, yet its personal computers were highly competitive with IBM's. Today, Compaq's sales are 35 percent as large as IBM's overall and it has surpassed that company in sales of personal computers. The morals of this history lesson are (1) small guys can compete effectively and (2) if they are successful, they grow up to join the big guys.

V. U S WEST HAS NEITHER THE INCENTIVE NOR THE ABILITY TO ENGAGE IN ANTICOMPETITIVE BEHAVIOR

The opponents of U S WEST's petition warn of the twin dangers of cross subsidization and predatory pricing. With regard to the former, the question arises of what prices would be raised to fund the putative anticompetitive behavior. For firms subject to partial regulation, there are three groups of prices that might arguably be increased in order to finance cross-subsidization—prices for services subject to (1) nondominant regulation; (2) federal price cap rules; and (3) state regulation. None of these price increases would be possible under U S WEST's proposal, for reasons we proceed to enumerate.[12]

First, although nondominant regulation of high capacity services in Phoenix could allow U S WEST to *raise* those prices, that would hardly make sense as a means of financing the cross-subsidization of its sales of those same services: the opponents of the regulatory change that U S WEST proposes here can hardly have it both ways—that their fear is, at one and the same time, that when subjected to less stringent regulation, U S WEST would compete unfairly

[12] The intervening parties allude to another asserted competitive problem stemming from U S WEST's asserted control of bottleneck facilities. The first and most critical answer is that U S WEST has no such power in the market in which it requests non-dominant treatment, because this market is competitive. That is, the existence of CLEC facilities and their ability to expand those facilities have eliminated whatever bottleneck existed in the high capacity market in Phoenix. Second, for other markets, bottleneck control presents a problem in the current instance only insofar as it might permit U S WEST to raise its charges for access to those facilities for the purpose of cross-subsidizing its high capacity offerings in Phoenix. As we describe presently, current regulation is sufficiently strong to preclude this possibility. Moreover, it would obviously be irrational and perverse to retain unnecessary and harmful regulation of the high-capacity market in Phoenix, at the expense of consumers there, on the basis of the conception that competition in other local exchange markets is weak. Maintaining unnecessary regulation in the high capacity market on the basis of the state of competition in other local exchange markets would impose unnecessary costs on both U S WEST and Phoenix customers.

with them in the sale of its high-capacity services in Phoenix by at one and the same time reducing those prices and raising them in order to finance those reductions. Nor would it make sense for it to raise the prices of such services, subject to nondominant regulation elsewhere, when the basis for that regulatory change is or would have to be a finding that those prices are sufficiently constrained by competition to prevent raising them in this way.

As for the second possibility—namely, that U S WEST could raise other prices subject to federal price cap regulation--as a matter of simple arithmetic, it would have *less* flexibility to raise those prices if its high capacity services in Phoenix were to be granted nondominant treatment and removed from price caps. This would be so because removal of those services from the price caps would mean that when and if U S WEST exercised its newly conferred freedom to reduce them, it could no longer use those reductions to offset increases in its charges for other price-capped services.[13]

As for the third possible source of cross-subsidy, the simple answer is that these prices are regulated at the state level; U S WEST has no authority to raise them unilaterally.

The fact is that the specter of cross-subsidization is a hobgoblin. To the extent that the putatively cross-subsidizing services are unregulated, U S WEST would presumably have already been setting their prices at the profit-maximizing level; if, then, it decided to exercise its newly conferred freedom to reduce the prices of its high-capacity services in Phoenix, in order to meet competition, there would be no point in its attempting to recover those "losses" by raising the prices of the other services—since there would have been no reason for it not to

[13] The same arithmetic provides the answer to the opponents' concern that U S WEST has not made sufficient use of the price flexibility it has under zone pricing. Use of this flexibility would require U S WEST to lower prices throughout the low-priced zone, not just in those areas competitors have targeted for entry. The loss of revenue in the non-targeted areas is a cost competitors do not face when they reduce prices. Nondominant treatment would eliminate that asymmetry.

In addition, there are competitive benefits from nondominant status that go well beyond pricing flexibility. In a market where its competitors are offering sophisticated new packages, as witnessed by the announcements of both AT&T and MCI WorldCom at the completion of their recent mergers, failure to grant U S WEST similar flexibility in the form of the ability to offer products and change prices with minimal notice would (1) dampen its incentives to offer new products, (2) dampen its incentives to lower prices, and (3) provide its competitors an unfair competitive advantage, because they alone would have advance notice of their major competitor's plans.

have been pricing them at the most profitable level already. To the extent, instead, that the putatively cross-subsidized services were regulated, there is no reason why the regulators of those other services would permit their prices to be increased merely because U S WEST had decided to reduce its prices of newly liberated services in Phoenix.

Turning to predatory pricing, the crucial question is whether such prices could drive competitors out of the market and keep them out long enough for U S WEST to be able to recoup its losses by higher prices after their departure. In fact, it is extremely unlikely predation could be successful. The facilities-based competitors already have a great deal of capacity installed: firms do not exit from markets unless the prices fall and are held below their variable costs; and the very wide gap between total costs and marginal costs of capacity already in place suggests that any attempt at predation would in any event be extremely costly; the predator would have to push prices far below its own total costs and suffer large losses before it would have any hope of driving its rivals from the market. Moreover, even if U S WEST's price reductions drove out such particularly unlikely targets for successful predation as AT&T, they would not drive out *facilities* already installed: the only circumstances under which it would not be profitable for anyone to continue to use those facilities would be if either that continued use were inefficient, because the marginal cost associated with it were higher than the marginal costs incurred by the incumbent, or if the incumbent persisted in pricing its competitive services below its own marginal costs—but for what purpose? Any attempt on its part to recoup those losses by raising rates above competitive levels would not have to be combatted by the construction of new facilities. At that point, because the competing facilities would already be in place, some firm—whether the previous rivals or some successor—would find it economic to resume operating them. In a recent proceeding, the FCC employed almost identical logic in defending its proposal to give ILEC's increasing freedom to offer contractual rates:

> We do not believe that our contract carriage proposal will lead to predatory pricing as such contracts must be made generally available and are typically long term. Further, ... predatory pricing is likely to occur only if a carrier can eliminate competition and continue to deter potential competitors from entering the marketplace. Once competitors have invested substantial sunk costs

necessary to participate in the access market, the existence of those facilities will deter the incumbent from raising rates in the future.[14]

VI. CONCLUSION

In our opening paper, we followed the approach the FCC has previously used to assess market power for other services. Our analysis concluded that the market for high capacity services in the Phoenix area fully exhibits its stipulated indicia of competition. In particular, (1) U S WEST has a diminishing market share—indeed, it serves only 30 percent of the retail market—and is barely providing one-half of the facilities that serve new demand; (2) customers are highly sensitive to price and other dimensions of service; (3) U S WEST's existing competitors can readily expand their capacity sufficiently to displace it entirely, if it were to attempt to price monopolistically, and, in addition, barriers to entry are minimal; and (4) U S WEST's size gives it no insurmountable advantage. Indeed, these indicia all reflect intensifying competition, which strongly suggests that if the FCC grants U S WEST's Petition, there is virtually no likelihood that it will ever regain a dominant position that would call for reregulation. Competition itself, without dominant firm regulation, is sufficient to restrain the Company's ability to impose anti-competitive prices and other conditions.

Although the intervening parties, AT&T and MCI WorldCom prominently among them, have disagreed with our conclusions, their recent actions in the marketplace are entirely consistent with our analysis. In particular, AT&T's recent acquisition of Teleport and the joining of forces of MCI and WorldCom put these firm in a strong position to continue to attract business customers with packages of services that U S WEST cannot yet offer and to divert traffic from ILECs' facilities to its own. In light of these developments, the costs of maintaining dominant firm regulation in this market clearly exceed whatever benefits continued regulation could possibly confer. In particular, as the FCC has noted elsewhere, at a time when

[14] Federal Communications Commission, In the Matter of Price Cap Performance Review for Local Exchange Carriers, CC Docket No. 94-1, Treatment of Operators Services Under Price Cap Regulation, CC Docket No. 93-124, Revisions to Price Cap Rules for AT&T, CC Docket No. 93-197, *Second Further Notice of Proposed Rulemaking in CC Docket No. 94-1, Further Notice of Proposed Rulemaking in CC Docket No. 93-124, and Second Further Notice of Proposed Rulemaking in CC Docket No. 93-197*, September 20, 1995, p. 68

competitors such as AT&T and MCI WorldCom are expanding their product offerings, continued dominant regulation of U S WEST imposes the following costs: (1) the longer tariff notices imposed on it dampen its incentives to innovate, because rivals could respond to its innovations even before it could actually offer them; (2) these same filing requirements dampen its incentives also to reduce prices; (3) its competitors can use the asymmetrical regulatory process to delay and undermine its initiatives; and (4) regulation imposes administrative costs on all parties.

ATTACHMENT B

DECLARATION OF William R. Kopp

1. My name is William R. Kopp and my business address is 1295 South Eagle Flight Way, Boise, ID 83709.

2. My position with POWER Engineers, Inc. ("Power") is Project Manager. In that capacity, I supervised the preparation of the Power Engineers Cost Study contained in U S WEST Communications, Inc.'s ("U S WEST") Forbearance Petition for high capacity services in Phoenix, Arizona.

3. I have reviewed the comments that MCI WorldCom, Inc. ("MCI") filed in opposition to U S WEST's forbearance petition. In particular, I am familiar with MCI's criticisms of Power's estimate of the costs of extending CAP facilities to additional buildings.

4. MCI asserts that Power failed to include many critical cost elements and states that its experience indicates that the "true" costs of adding a building to a CAP network should be at least four times greater than Power's estimates. I disagree with MCI's claims. In my opinion, Power's Cost Study met its objective – which was to provide a reasonable estimate of the "broad-gauge" costs of constructing connections to a large number of locations. The Study's Executive Summary states that the cost estimates are "sufficiently accurate for capital budget planning purposes . . . but not suitable for site specific costs." As a result, I would not expect that Power's estimates would be representative of the costs of building-out CAP facilities to any particular building on an individualized basis.

With the exception of a few clarifications that I will provide in this Declaration, Power's Cost Study is self-contained and speaks for itself. The study contains the cost model that Power developed to respond to U S WEST's request along with the underlying assumptions. I believe that the assumptions that were employed are reasonable and that the cost model includes all relevant cost elements.

While MCI is quick to criticize Power's cost estimates, it offers nothing other than the off-hand comment that it spends four times as much to add a building to its network. Needless to say, it is impossible for me to comment on the validity or invalidity of MCI's cost characterizations without more information. However, one must keep in mind that Power's study estimates the minimum cost of a large scale build-out to extend CAP facilities to duplicate the service level currently provided by U S WEST. In other words, what would it cost CAPs to extend their networks to serve U S WEST's existing high-capacity customers and how long would it take. I believe that Power's study does a good job of answering these questions.

5. I will now respond to MCI's specific criticisms:

(a) MCI claims that Power should have included the cost of add-drop multiplexers or other connection nodes in its estimates. I disagree.

As noted in the Study under Assumptions 1 and 3 of Section 4, "Equipment Costs," Power assumed that the competing carrier(s) would be adding to an existing SONET system, in which case initial capital outlays and early-year administrative expenses could be minimized by adding point-to-point systems sized for the initial requirement. For instance, in the case of an initial order for three DS1 channels, only a fiber driver transmit/receive plug set (the point-to-point Quad DS1 system) need be added, at an incremental additional cost.

Power is aware that carriers sometimes place a high capacity SONET system, such as an OC3 (84 DS1's) or OC12 (336 DS1's) at the customer premise upon initial installation of a small number of lower rate channels, such as DS1's. These require a node, such as an add-drop multiplexer to "drop" the required number of DS1 channels from the high capacity system at the location. This increases initial capital outlays and administrative costs (the costs to manage the channels dropped from the system via the multiplexers) but reduces future capital expenditures if the customer adds circuits.

The minimum initial cost approach assumed by Power involves placing a point-to-point system (such as the Quad DS1 system for small numbers of DS1 channels) which does not require a multiplexer at the customer location. Placing a DS-1 add-drop multiplexer for these low volume DS1 requirements would add approximately 30% to the equipment costs.

(b) MCI also claims that Power Engineers failed to include inside wiring costs. These costs were included, but Power inadvertently failed to document these costs in its report. Inside wire costs were estimated as follows:

(i) The length and width of the buildings were measured at each sample location.

(ii) It was assumed that inside cable would be extended for 50% of the length and 50% of the width inside the building.

(iii) It was assumed, for multi-story buildings, that the cable would need to be extended to half the total building height, as an average (Power Engineers did not have data on the floor location or customer name for multi-tenant high rise buildings).

(iv) The inside wiring material costs (cable, support equipment and terminating equipment) were estimated based upon the lengths described above and loaded with estimated labor cost factors.

(c) MCI claims that Power Engineers did not include any building entrance fees. MCI is correct. Power Engineers did not include any such costs because of the wide variety of arrangements and circumstances associated with the assessment or non-assessment of such fees by building owners. Clearly, the presence and bargaining power of major tenants has a significant impact on the behavior of building owners. In those cases where a building is owned by the primary occupant, building entrance fees are much less likely to be assessed regardless of the carrier.

Power did not believe that it could estimate building entrance fees with any degree of accuracy and, therefore, did not include them. Clearly, the assessment of such costs could increase the costs of building-out facilities to some extent.

(d) MCI also takes issue with Power's estimates of the time required to construct facilities. Power stands by its original assessment. As MCI states, if viewed as a single, stand-alone event, building a loop to a given customer location may require three months or more, including engineering time, permit application and approval, and construction.

Power's time estimates were based, however, on a major construction program in which loops to existing U S WEST locations would be built in the course of a coordinated single effort. Power Engineers anticipates that several months may be required from the time the build decision is made until construction on the first loop begins. However, it is Power's expectation that engineering and permit filings for subsequent locations would proceed immediately, parallel in time with the various activities for the first location.

This sequenced, coordinated approach could prevent the time required for engineering and permit application for subsequent locations from inserting serial time delays in the overall construction program.
It should be noted that a large percentage of present U S WEST high capacity customer locations are within 1,000 feet of the nearest CAP fiber optic cable route, and many are within 100 feet. If CAPs focused on these "close-in" locations, the build time could be significantly less than Power estimated for all U S WEST locations.

6. This concludes my declaration.

Pursuant to 47 C.F.R. Section 1.16, I declare under the penalty of perjury that the foregoing is true and accurate to the best of my belief.

Executed this 27th day of October, 1998.

William R. Kopp
Project Manager
POWER Engineers, Inc.

STATE OF IDAHO)
) SS.
COUNTY OF ADA)

On this 23rd day of October, in the year of 1998, before me Sandra M. Gabica, a notary public, personally appeared WILLIAM R. KOPP , personally known to me to be the person whose name is subscribed to the within instrument, and acknowledged to me that he executed the same.

Sandra M. Gabica
Notary Public
Residing at Boise, ID
My Commission Expires 3/7/2000

CERTIFICATE OF SERVICE

I, Rebecca Ward, do hereby certify that on this 28th day of October, 1998, I have caused a copy of the foregoing **REPLY COMMENTS OF U S WEST COMMUNICATIONS, INC.** to be served, via United States Mail,* postage prepaid, upon the persons listed on the attached service list.

Rebecca Ward

Rebecca Ward

*Served via hand delivery

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